Before the FEDERAL COMMUNICATIONS COMMISSION Washington, D.C. 20554

In the Matter of)		
Federal-State Joint Board on Universal Service)))	CC Docket No. 96-45	

COMMENTS OF SBC COMMUNICATIONS INC.

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SBC Communications Inc. (SBC) hereby submits its Comments in response to the Commission's Notice of Proposed Rulemaking seeking comment on universal service issues remanded by the United States Court of Appeals for the Tenth Circuit.¹

More than six years after Congress codified universal service requirements in section 254 of the Act and opened the local exchange market to competition, federal and state regulators have yet to establish a comprehensive plan for advancing and preserving universal service in a competitive environment. That is what this proceeding ultimately must be about. The "patchwork quilt" of implicit subsidies that continues to serve as the primary source of universal service support is not just fraying at the edges; it is full of holes and falling apart.

The Tenth Circuit's mandate to the Commission is extremely broad.² The Commission must (i) define the key statutory universal service requirements of section 254, (ii) explain how its universal service plan satisfies these statutory requirements, (iii) assume responsibility for ensuring that states take action to preserve and advance universal service, and (iv) explain how the federal universal service mechanism will interact with other universal service mechanisms to

¹ Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Notice of Proposed Rulemaking and Order, 17 FCC Rcd 2999 (2002) (NPRM).

² The court's mandate is necessarily broad because the conclusions reached by the Commission in the *Ninth Universal Service Order* represent the culmination of policy decisions made in previous universal service orders.

create a complete plan for supporting universal service.³ In order to comply with the court's mandate and the requirements of section 254, the Commission must do much more than simply defend its reverse-engineered 135 percent benchmark model, compare rural and urban prices, and encourage the states to implement universal service reforms.

Instead of seeking to maintain the status quo, the Commission should conduct a comprehensive reform proceeding to replace the outdated system of implicit subsidies with a national plan for universal service. SBC proposes that the Commission implement a three-step approach to universal service reform that integrates federal and state universal service support mechanisms in a manner that is consistent with the Act and sustainable in a competitive environment. First, the Commission should establish an affordability benchmark based on the median household income of a particular geographic area (e.g., a county). Commission should establish an integrated universal service mechanism that provides funding for geographic areas where the forward-looking cost of providing service exceeds the affordability benchmark. Third, the Commission should establish a transition plan that allows residential local prices to rise to levels that are self-supporting and affordable. This approach will ensure that residential local prices are "just, reasonable and affordable" and "reasonably comparable" between rural and urban areas, while also producing a universal service support mechanism that is "specific, predictable and sufficient." It also will facilitate intercarrier compensation reform and remove barriers to competition in the residential local market.

³ *Qwest v. FCC*, 258 F.3d 1191, 1201 (10th Cir. 2001).

I. Introduction and Summary

For almost 100 years, federal and state regulators have relied on a "patchwork quilt" of implicit subsidies to ensure that every American has affordable access to the local telephone network. As the Commission has recognized, state rate designs have provided implicit universal service support flowing from (1) urban areas to rural areas, (2) business customers to residential customers, (3) vertical services to basic service, and (4) toll service to local service. In its simplest terms, these implicit subsidies represent a flow of revenues within a company that is necessitated by a regulator capping the price of a particular service below cost. It was fairly easy to maintain a universal service system based on implicit subsidies in a monopoly environment because, in the absence of competition, carriers typically were able to meet their revenue requirements and earn a reasonable return on investment.

That all changed with the adoption of the Telecommunications Act of 1996 (1996 Act) and the introduction of competition into the local exchange market. The 1996 Act reshaped the foundation of the telecommunications market and, in the process, exacerbated many of the problems created by the complex system of price controls and implicit subsidies that were in place. As the Commission itself has recognized "[t]hese types of implicit subsidies cannot be sustained . . . in the competitive markets for telecommunications services envisioned by the 1996 Act."⁵

Congress, recognizing the potential tension between the policy goals of local competition and universal service, adopted section 254 as part of the 1996 Act to ensure the preservation and

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⁴ Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Ninth Report and Order and Eighteenth Order on Reconsideration, 14 FCC Rcd 20432, at ¶ 15 (1999) (Ninth Universal Service Order), aff'd in part, rev'd in part and remanded by Qwest v. FCC. Another example of a source of implicit universal service support is switched access.

⁵ Implementation of the Local Competition Provisions in the Telecommunications Act of 1996 and Intercarrier Compensation for ISP-Bound Traffic, CC Docket Nos. 96-98 and 99-68, Order on Remand and Report and Order, 16 FCC Rcd 9151, at ¶ 4 (2001), appeals docketed, Nos. 01-1218 et al. (D.C. Cir. May 17, 2001).

advancement of universal service in the new competitive environment. Therefore, at the same time it gave the Commission broad authority to open local markets to competition, Congress gave the Commission a mandate to reform universal service and establish a national plan to ensure that universal service support is "specific, predictable and sufficient." In stark contrast to the Commission's sweeping actions to implement the local competition provisions of the 1996 Act, the Commission's approach to universal service reform preserved the status quo and left in place much of the outdated system of implicit universal service support.

As discussed further below, the Commission has acknowledged the widespread reliance on implicit subsidies in intrastate prices to support universal service, yet the Commission has done nothing to address the issue. Rather, the Commission chose to reverse engineer a forward-looking cost model that achieved its stated goal of ensuring that the amount of federal high-cost funding would not increase significantly. By using statewide average loop costs in its forward-looking cost model and comparing those statewide average costs to national average loop costs, the Commission was able to significantly understate costs and limit the size of the federal universal service fund. The results of the Commission's approach to universal service reform speak for themselves. Competitors in the local exchange market have targeted the business market and high-volume residential customers while largely ignoring the rest of the residential market. This has led to the rapid erosion of implicit universal service support and distorted competition by making it uneconomic to serve many residential customers in the absence of subsidized market entry.

The *NPRM* appears to assume that the current universal service mechanism can be maintained if the Commission provides a better explanation for setting the funding benchmark at 135 percent of the national average, provides a definition of statutory terms such as "reasonably comparable," and encourages the states to implement universal service reform. It should be apparent, however, that the Tenth Circuit's remand raises much broader and more fundamental concerns about the Commission's approach to universal service. Moreover, the decision-making process described in the *NPRM* is completely backwards. The Commission cannot evaluate its

funding benchmark and define "reasonably comparable" first and defer to a later date the critical issues of state participation in universal service reform and the Commission's comprehensive plan for universal service support. Only *after* the Commission establishes an integrated universal service mechanism that includes the necessary state inducements and agreements will the Commission be in a position to determine the amount of federal universal service support that is needed.⁶

SBC proposes that the Commission implement a three-step approach to universal service reform. First, the Commission should establish an affordability benchmark based on the median household income of a particular geographic area (e.g., a county). Second, the Commission should establish a universal service mechanism that provides funding for geographic areas where the forward-looking cost of providing service exceeds the affordability benchmark. The combined amount of explicit federal and state universal service support would give carriers enough funding to pay for the difference between the affordability benchmark in a geographic area and the forward-looking cost of providing service in that same area. Third, the Commission should establish a transition plan that allows residential local prices to rise to levels that are self-supporting and affordable.

This approach strikes a reasonable balance among the statutory universal service requirements of section 254. It will produce a comprehensive universal service plan that provides "specific, predictable and sufficient" universal service support, unlike the current collection of disjointed mechanisms that rely primarily on implicit universal service support. It will produce local prices that are "just, reasonable and affordable." It will ensure that prices paid by consumers in "rural, insular, and high cost areas" are "reasonably comparable" to the prices paid by consumers in urban areas. The Commission cannot assess whether prices in rural areas are reasonably comparable to prices in urban areas until after implicit subsidies are eliminated

⁶ Indeed, the fact that section 254(a) required the Commission to institute and refer universal service issues to a Federal-State Joint Board clearly signals Congress' intent for integrated federal and state universal service mechanisms and policies, as opposed to a continuation of the Commission's prior approach.

and residential local prices rise to affordable levels. Moreover, the implementation of universal service reform will facilitate intercarrier compensation reform and remove barriers to competition in the residential local market. The pro-competitive goals of the 1996 Act will never be fully realized until residential local prices rise to levels that are self-supporting and, therefore, attractive to competitors.

The Commission has broad authority to implement a national plan for universal service. Section 254 significantly expands the Commission's authority over universal service issues and imposes many requirements directly on the states. Indeed, the Tenth Circuit held that the Commission has an obligation to ensure that states take the necessary action to achieve the universal service requirements of section 254 and must "develop mechanisms to induce adequate state action" to implement the statutory goals of universal service. As with other provisions of the 1996 Act, the Commission has rulemaking authority to carry out the provisions of section 254 in a manner that preserves the states' authority to regulate intrastate prices. An additional basis of authority for implementing universal service reform is that such reform is a prerequisite for establishing end-user recovery mechanisms for reciprocal compensation arrangements governed by section 251(b)(5).

II. The Commission's Current Approach to Universal Service Has Not Eliminated Implicit Subsidies and Should be Abandoned

SBC will not revisit the extensive history of the Commission's universal service proceedings here. With respect to the specific issues remanded by the Tenth Circuit, however, SBC believes the court's concerns are the direct result of the Commission's failure to address the problems created by the outdated system of implicit universal service support.

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⁷ Qwest v. FCC, 258 F.3d at 1204.

⁸ AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366, 380 (1999) (citing 47 U.S.C. § 201(b)).

The Commission is well aware of these problems. Indeed, the Commission has recognized the competitive distortions that are created by the combination of implicit subsidies and below-cost residential local prices:

[E]fforts to sustain implicit universal service support in a competitive environment could encourage business decisions contrary to the purpose of high-cost support For example, competitors may be more likely to target high-revenue business customers in low-cost urban areas where incumbent LECs are charging rates significantly above costs, while foregoing opportunities to serve lower-revenue residential customers in high-cost rural areas where incumbent LECs are charging artificially low rates because of implicit support flows.⁹

Instead of tackling this difficult and politically sensitive issue, however, the Commission determined that "the federal fund should not increase substantially." In effect, the Commission made a policy decision that it would not take any action to reduce, let alone eliminate, the reliance on implicit subsidies as the primary source of universal service support. Nor did the Commission adopt any requirements or inducements for states to replace intrastate implicit universal service support with a combination of self-supporting residential local service prices and explicit universal service support where it is needed to maintain affordable prices. The statutory goals of universal service will never be realized until implicit subsidies are eliminated and prices for residential local service are self-supporting.

The Commission's desire to maintain the existing size of the federal high-cost fund led it to reverse engineer a flawed forward-looking cost model that significantly understates costs. The Hybrid Cost Proxy Model that was adopted in the *Ninth Report and Order* uses algorithms that understate the costs driven by variables such as customer location, wire center boundaries, and wire center demand. Although there may be public policy reasons for using a forward-looking

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⁹ Ninth Universal Service Order, at ¶ 16.

¹⁰ Federal-State Joint Board on Universal Service; Access Charge Reform, Seventh Report and Order and Thirteenth Order on Reconsideration in CC Docket No. 96-45 and Fourth Report and Order in CC Docket No. 96-262 and Further Notice of Proposed Rulemaking, 14 FCC Rcd 8078, at ¶ 52 (1999) (Seventh Universal Service Order).

approach to calculate universal service support, the use of a purely hypothetical model that has no basis in reality is a completely different matter. Use of company-specific or even statespecific inputs would have been a more reasonable approach that would have yielded far more accurate results.

In addition, the Commission's use of nationwide average inputs for variables such as switching and interoffice facilities investment, loop investment, installation costs and plant mix values has the effect of distorting the cost structure of high-cost areas. The Commission's comparison of statewide average costs to national average costs ignores the identification of high-cost areas within a state that are in need of universal service support. This use of nationwide average costs in the high-cost support mechanism only serves to perpetuate the reliance of on implicit subsidies flowing from low-cost areas to high-cost areas. The result of the Commission's benchmark model is that non-rural ILECs receive federal high-cost funding support in only 11 states (and Puerto Rico), which means that non-rural ILECs such as SBC do not receive any such support, even in largely rural states such as Arkansas, Oklahoma and Texas. 11 Given these results, it should be obvious that states containing major urban areas will not qualify for universal service support, even though much of their overall territory is considered rural.

These manipulations of the cost model must be corrected in this proceeding; otherwise the amount of universal service support will not be sufficient, as required by section 254, and residential local service prices will continue to be supported by implicit subsidies. It should be noted that, although the Tenth Circuit found that Qwest failed to present evidence that the Commission's model produces such inaccurate results that it cannot form the basis of rational decision-making, 12 the court was unable to evaluate the results of the model. As the court itself

¹¹ See Attachment A (Universal Service Monitoring Report: High Cost Support by Jurisdiction).

¹² Owest v. FCC, 258 F.3d at 1206.

noted, the Commission's failed to provide "sufficient reasoning or record evidence" to support the reasonableness of its approach to universal service.¹³

The Commission's approach to universal service reform has allowed implicit subsidies to continue unabated. ¹⁴ If anything, the Commission has exacerbated the problem. In particular, the Commission added more than \$2 billion annually to the universal service system through the establishment of the schools and libraries fund. Yet the Commission also decided to keep the federal high-cost fund approximately the same size, regardless of the amount of explicit universal service support that is actually needed. The Commission also has taken billions of dollars of implicit support out of the system without substituting adequate explicit universal service support mechanisms. These policy decisions all removed a significant portion of the revenues that carriers rely on to support the preservation and advancement of universal service. As a result, the universal service system is under more stress than ever without any action being taken to end the reliance on implicit universal service support and rationalize local prices.

Further, the Commission gave the states the responsibility for ensuring reasonable comparability of prices within their borders with full knowledge that the states were achieving this result using intrastate implicit support mechanisms.¹⁵ The Commission will learn in this proceeding that the situation in the states is bleak. Many states have capped ILEC residential local prices without regard to the actual costs of providing service.¹⁶ In SBC's region, three states have not changed residential local prices in *five* years and two states have not changed

¹³ *Id.*, at 1195.

¹⁴ SBC does not want to understate the political difficulty of raising residential local service prices to self-supporting levels. However, this "difficulty factor" is exactly why the Commission must take a leadership role in designing and implementing a national universal service plan that achieves the goals established by Congress.

 $^{^{15}}$ Ninth Universal Service Order, at \P 46; see also Seventh Universal Service Order, at \P 45.

¹⁶ As former FCC Chairman William Kennard observed, "[o]ne of the dirty little secrets in America is that most people pay less for phone service than it costs to provide." 8 Lessons from the Telecom Mess, Business Week Online (Aug. 13, 2001).

residential local prices in ten years. Of those states that have changed prices recently, four states increased residential local prices, but four states decreased residential local prices. Attachment B hereto is a chart showing the highest price of residential local service in each state in SBC's region, as well as the date the price was last changed.

Moreover, some states have set residential local prices according to the number of people in the local calling area, which produces the *lowest* prices in the *highest-cost*, lowest-density areas. In Texas, for example, the most sparsely populated rural calling areas pay the lowest monthly price of only \$8.15, whereas the most densely populated urban areas pay a monthly price of \$11.15. The situation is similar in Missouri, where the monthly price in the most sparsely populated rural area is only \$7.42 and the price in the most densely populated urban areas is \$12.30. The result is that regulated prices for ILEC residential local services often bear no relation to the costs of providing the service. Further, these prices often are the product of traditional intrastate ratemaking rules that relied upon residual pricing principles. This residual pricing methodology required prices for discretionary services such as vertical services, toll and switched access, as well as prices for some business services, to be set at artificially high levels so that residential local prices could be set below cost and still allow for overall recovery. 17

Some states, including four states in SBC's region, have not even established explicit universal service funds. In those states that have established universal service funds, contributions to the state funding mechanisms are driven by measures of intrastate activities, such as intrastate minutes of use and intrastate revenues. Despite the fact that SBC is one of the primary contributors to these state funding mechanisms, there are a number of states where SBC does not receive any support from the state fund. This has occurred against the backdrop of the limited federal high-cost funding that SBC used to receive being totally eliminated under the Commission's universal service plan. Thus, the situation is actually worse than it was prior to the 1996 Act.

¹⁷ Ninth Universal Service Order, at ¶ 15.

The results of the Commission's approach speak for themselves. It is inevitable that, in a competitive market, ILECs that are dependent on switched access prices and business service prices as sources of implicit subsidies will lose customers to competitors that do not need to subsidize below-cost services.¹⁸ It also is inevitable, as the Commission has recognized, that subsidies distort business decisions by competitors, driving them to target high-revenue business customers in low-cost areas and to ignore residential customers in higher-cost areas where ILECs are charging below-cost prices.¹⁹

There is concrete market data that proves this is happening. A recent Commission report on the status of local telephone competition showed that, as of June 30, 2002, competitors had successfully captured about 20 percent of the market for medium and large businesses, institutional and government customers nationwide, while largely ignoring the residential market.²⁰ The report also showed that about 55 percent of CLEC local telephone lines provide service to medium and large business, government and institutional customers, compared to 23 percent of ILEC lines for the same category of customers.²¹ SBC recently filed a report with the Commission indicating that CLECs likely supply closer to 28 percent of all business lines nationwide.²²

The current situation is unsustainable. As ILECs lose low-cost, high-revenue customers to competitors or reduce their prices to stem such loses, the implicit support for residential

¹⁸ *Id*.

¹⁹ *Id.*, at ¶ 16.

²⁰ See FCC Report, Local Telephone Competition: Status as of June 30, 2001, at Table 2 (February 2002).

²¹ *Ninth Universal Service Order*, at ¶ 16.

 $^{^{22}}$ See UNE Fact Report 2002 at IV-2 (filed with SBC Comments in CC Docket Nos. 01-338, 96-98 and 98-147 (Apr. 5, 2002)).

services necessarily disappears.²³ It is precisely for this reason that Congress established a requirement that federal and state universal service mechanisms must be "specific, predictable and sufficient."²⁴ The Commission does not have the authority to ignore or second-guess Congress' determination that universal service support should be explicit, rather than implicit. In fact, the Fifth Circuit held that "the plain language of Section 254(e) does not permit the FCC to maintain implicit subsidies,"²⁵ and it determined that the Commission could not even *allow* carriers to recover universal service costs through access charges because such recovery constitutes an unlawful implicit subsidy.²⁶

Further, carriers that are forced to generate their own implicit subsidies bear the entire funding burden of supporting universal service, which is contrary to the requirements of sections 254(d) and (f) that all carriers that provide interstate and intrastate telecommunications services contribute in an equitable and nondiscriminatory manner. For these reasons, the only type of funding mechanism that can satisfy the requirements of section 254 is one that provides explicit universal service support. Thus, the elimination of implicit subsidies is a statutory imperative, as well as an important policy goal.

III. The Commission Should Take the Lead in Implementing an Affordability-Based Approach to Universal Service

SBC proposes that the Commission implement a three-step approach to universal service reform. First, the Commission should establish an affordability benchmark based on the average household income of a particular geographic area (*e.g.*, a county). Second, the Commission

²³ Ninth Universal Service Order, at ¶ 16. Each customer that an ILEC loses to a competitor results in the loss of implicit subsidy revenues from interstate and intrastate switched access charges, common line charges, toll services and vertical features.

²⁴ 47 U.S.C. § 254(b)(5).

²⁵ Texas Office of Pub. Util. Counsel v. FCC, 183 F.3d 393, 425 (5th Cir. 1999) (TOPUC v. FCC).

²⁶ Comsat Corp. v. FCC, 250 F.3d 931, 938-39 (5th Cir. 2001).

should establish a universal service mechanism that provides funding for geographic areas where the forward-looking cost of providing service exceeds the affordability benchmark. The combined amount of explicit federal and state universal service support would give carriers enough funding to pay for the difference between the affordability benchmark in a geographic area and the forward-looking cost of providing service in that same area. Third, the Commission should establish a transition plan that allows residential local prices to rise to levels that are self-supporting and affordable.²⁷

A. Establishing an Affordability Benchmark

SBC recognizes that the removal of implicit subsidies and the implementation of a unified bill and keep regime will result in an increase in most prices for residential local service. Nevertheless, it is important for the Commission to break with the past and establish a new public policy that a business or residential customer should not be compelled to pay for a portion of another non-Lifeline customer's telephone service — through an explicit or implicit universal service support mechanism — except in rare circumstances. SBC proposes that the Commission also implement a comprehensive universal service plan that will provide support in those geographic areas where compensatory prices cease to be affordable. This will require a coordinated effort between the Commission and the states; a partnership envisioned by the Act and reiterated by the Tenth Circuit. In order to implement such a comprehensive plan, the Commission will have to go further than its traditional cost-based approach to universal service and consider whether the net effect of residential local service pricing reform and universal service support reform makes quality services available at "just, reasonable, and affordable rates," as required by section 254. With the exception of Lifeline customers, universal service support should be limited to those residential customers who reside in geographic areas in which

²⁷ In those cases where the forward-looking economic cost of providing service exceeds the affordability benchmark and residential local prices currently are below the affordability benchmark, those prices should rise to the affordability benchmark level.

prices would be unaffordable in the absence of such support. Non-Lifeline customers in all other areas should pay unsubsidized prices for telephone service.

SBC believes that "affordability" represents an end user's ability to bear the cost of service relative to household income. Universal telephone service prices represent a household expense, just as cable television prices, automobile prices, food prices and prices paid for entertainment are household expenses. Other types of household expenses should be reviewed to determine a benchmark level for local telephone service that would be considered "affordable."

Prices that exceed this affordability threshold for a given geographic area would be considered unaffordable and would trigger the availability of explicit universal service support. Universal service support for financially disadvantaged individuals should be addressed by the Lifeline mechanism and increased if necessary.

The Bureau of Labor Statistics recently released data to summarize the various sources of income, as well as to summarize common household expenses. This data indicates that, on a nationwide aggregate level, a typical household spends 2.1 percent of its annual income on telephone-related expenses.²⁹ However, local telephone service is only one component of this category of household expenses. According to data released by the Commission, the household expense associated with local telephone service is approximately 54 percent of total telephone-related expenses,³⁰ which means that, based on current prices, local telephone service expenses constitute approximately 1.2 percent of annual household expenses.

²⁸ An affordable household expenditure level could be expressed as a percentage of median household income (median household income would be averaged over a pre-determined geographic area).

²⁹ See Attachment C (Selected Expenditures from Bureau of Labor Statistics Consumer Expenditures Report). A complete copy of the report is available at http://www.bls.gov/cex/2000/Standard/region.pdf.

³⁰ See Attachment D (Excerpt from the Federal Communications Commission Industry Analysis Division's Report: Trends in Telephone Services). A complete copy of the report is available at http://www.fcc.gov/Bureaus/Common Carrier/Reports/FCC-State Link/IAD/trend801.pdf.

In establishing an affordability benchmark, the Commission should compare local telephone service expenses to other categories of household expenses. For example, assuming that the Commission were to establish two percent as an affordability benchmark for local telephone service, Bureau of Labor Statistics data shows that this level of expense is less than the average household spends on energy expenses (3.2 percent), gasoline and motor oil (3.1 percent) and food away from home (5.1 percent). It is slightly more than the average household spends on television (including cable television service), radios and sound equipment (1.5 percent) and miscellaneous household equipment (1.8 percent).³¹ The benefit of this type of comparison is that it shows not only the relative magnitude of local telephone service expenses, but also the relation of such expenses to purely discretionary expenses, such as television. By conducting an analysis of typical household expenses, the Commission will be able to establish a reasonable affordability standard upon which to base the universal service funding mechanism.

B. Establishing a Universal Service Funding Mechanism

Once the Commission establishes an affordability benchmark, it should establish a universal service mechanism that provides funding in geographic areas where the forward-looking cost of providing service exceeds the affordability benchmark. The combined amount of explicit federal and state universal service support would give carriers enough funding to pay for the difference between the affordability benchmark in a geographic area and the forward-looking cost of providing service in that same area. While support can be raised in both the federal and state jurisdictions, there must be an integrated universal service mechanism that determines the *total* amount of universal service support that is needed for the entire nation.

Further, the same affordability benchmark and the same funding standard must apply to all carriers. The Commission cannot continue to limit non-rural ILECs to receiving support for the forward-looking cost of providing service while, at the same time, allowing rural ILECs to recover their actual embedded costs. The purpose of the universal service mechanism is to

³¹ See Attachment C.

provide maintain affordable prices in rural and high-cost areas, not to allocate support based on arbitrary categories of carriers. Non-rural ILECs provide service in many rural and high-cost geographic areas, and they can no longer be required to maintain below-cost prices in these areas by generating implicit subsidies from other customers in other geographic areas. In addition to being plainly inconsistent with section 254, this system of implicit subsidies undermines the Commission's pro-competitive policies by distorting competition. If these problems are not addressed, service in rural and high-cost areas will be endangered and non-rural ILECs may be forced to sell exchanges where prices are below cost.

SBC's proposed approach to universal service does not aim to fully reimburse carriers for their actual costs and eliminate all implicit subsidies. In particular, carriers would not recover their actual costs in geographic areas where such costs exceed either the forward-looking economic cost of providing service or the affordability benchmark. Nevertheless, SBC believes this conservative approach is reasonable, provided that carriers are able to recover their costs from revenue sources, such as vertical services, that are inseparable from the residential local service provided to the customer. At the same time, however, the Commission must end the reliance on implicit universal service support (*i.e.*, revenues) for residential local service flowing from other customers and other services as required by section 254.

C. Rationalizing Local Prices

The Commission has repeatedly stated that it intends to address the issue of implicit subsidies that provide support for below-cost prices for residential local service.³² It is critical that the Commission allow residential local prices to rise to levels that are self-supporting and affordable so that it can determine whether federal and state universal service mechanisms provide support that is sufficient to ensure the preservation and advancement of universal

³² See, e.g., Federal-State Joint Board on Universal Service, CC Docket No. 96-45, Report and Order, 12 FCC Rcd 8776, ¶ 8785 (1997), aff'd in part, rev'd in part and remanded by TOPUC v. FCC, cert. granted sub nom. GTE Serv. Corp. v. FCC, 530 US 1213 (2000), cert. dismissed 531 US 975 (2000); see also Ninth Universal Service Order, at ¶ 2 n.9.

service. An added benefit is that rationalizing local pricing structures will promote sustainable facilities-based competition in the residential local market.

Moreover, as SBC explained in the *Intercarrier Compensation* proceeding, the Commission cannot replace interstate and intrastate switched access charges with a bill and keep regime without first tackling the issues of end user pricing and universal service reform. Access charges are critical to recovering the costs of local service attributable to interexchange traffic. If those costs are not recovered through carrier access charges, then they must be recovered through appropriate end user charges. The Commission *cannot* eliminate switched access charges without first *ensuring* that there are federal and state end user recovery mechanisms in place.

Instead of attempting to identify the amount of explicit support needed to replace implicit subsidies from various sources such as toll charges, interstate and intrastate switched access charges, vertical services, business services and averaged prices, the Commission should focus on rationalizing residential local service prices. Specifically, the Commission should immediately initiate a proceeding to establish inducements or agreements for states to establish residential pricing structures that allow prices for residential local service to rise to levels that are self-supporting. This could be accomplished a number of different ways. SBC believes the best approach is for the Commission to establish general pricing standards and set a deadline for the states to put in place specific pricing structures that are consistent with these standards. A similar process has been used to implement the local competition requirements of the 1996 Act.

It should not be difficult to establish a "just and reasonable" standard for residential local prices. By incorporating a "just and reasonable" price standard as a universal service requirement in section 254(b), Congress merely incorporated the existing requirement of section 201(b) that prices for interstate services must be just and reasonable. The Commission has extensive experience ensuring that tariff terms and conditions – including prices – are just and reasonable under section 201(b). As SBC indicated in its *Intercarrier Compensation* comments, all carriers should be allowed to charge market-based prices that are self-supporting. The

Commission's pricing standards also should be flexible enough so that all carriers have the ability respond to market forces by implementing calling and pricing plans that meet the needs of customers. States would continue to have the authority to regulate prices for intrastate services, provided that their pricing structures are consistent with the Act and the Commission's implementing regulations.

As part of the transition to "just and reasonable" prices, the Commission must ensure that ILEC end user recovery is not limited to the forward-looking economic cost of providing service. At most, a hypothetical forward-looking economic cost methodology can be used to determine the amount of universal service support a carrier receives for providing service in a high-cost area. SBC recognizes that there are policy reasons for structuring universal service support in a manner that encourages carriers to minimize costs and operate efficiently. hypothetical forward-looking economic cost methodology is not an appropriate standard for setting prices for retail services. A pricing structure that caps residential local prices at hypothetical forward-looking economic cost would effectively represent a continuation of the current system of implicit subsidies and thus would not be sustainable. Further, such a pricing structure would be at odds with the Act's goal of promoting local competition. Instead, end user prices must be set at levels that are self-supporting and therefore attractive to competitors.

An Affordability-Based Approach to Universal Service Strikes a Reasonable IV. Balance Among the Statutory Universal Service Requirements of Section 254

Ultimately, the Commission's plan must be assessed in relation to the statutory universal service requirements that Congress codified in section 254. The Tenth Circuit rejected the Commission's argument that it was free to disregard requirements contained in section 254.33 Based on the plain language of the statute, the court held that the Commission may balance the requirements, "but must work to achieve each one unless there is a direct conflict between it and another listed principle or some other obligation or limitation" on the Commission's authority.³⁴

³³ *Qwest v. FCC*, 258 F.3d at 1200.

³⁴ *Id*,. at 1199.

Thus, the Tenth Circuit made clear that section 254 imposes a mandatory duty on the Commission to base its universal service policies on the requirements enumerated therein.³⁵ The affordability-based approach to universal service proposed by SBC strikes a reasonable balance among these statutory universal service requirements.

First, SBC's proposal is consistent with sections 254(b)(5) and (e) because it replaces most implicit universal service support with end-user recovery and explicit universal service support that is "specific, predictable and sufficient." The current system of implicit subsidies is not sustainable in a competitive environment, and it fails to comply with the statutory requirement that universal service support be specific and predictable. By implementing a combination of residential local service pricing reform and universal service support reform, the Commission can end the reliance on implicit subsidies and ensure that end users have access to affordable local telephone service. Implementation of these reforms also would satisfy the Commission's obligation to comply with the Tenth Circuit's remand.

For more than six years, the Commission has repeatedly acknowledged the difficulty of quantifying the amount and sources of implicit subsidies. As a result, the Commission has done little to address the issue, other than establishing a transitional universal service mechanism to replace some of the implicit universal service support that previously was embedded in interstate access charges. Rather than attempting to identify sources of implicit universal service support on an ad hoc basis, which is an impossible task, the Commission should begin by taking the lead in implementing end-user pricing reforms that would finally make prices for residential local services self-supporting. Once the Commission has ensured that implicit universal services support is no longer necessary, then it can determine whether there are any remaining sources of implicit subsidies that need to be addressed. In light of the rapid erosion of implicit subsidies that already has occurred as a result of competition and arbitrage, this should not even be an issue by the time the Commission and the states rationalize local prices.

³⁵ *Id.*, at 1200.

SBC's proposal to establish an affordability benchmark for a particular geographic area such as a county will result in federal and state universal service mechanisms that produce more targeted results than the use of statewide average costs and a nationwide average cost benchmark. Identifying median household income for a smaller geographic area in order to determine whether household expenditures for universal service are affordable resolves the issues caused by averaging data over large geographic areas, which has the effect of hiding those rural and high-cost areas that may require support. This feature of SBC's proposal will ensure that support is available and thus sufficient to maintain affordable prices in those rural and high-cost areas that need assistance.

In addition to eliminating implicit subsidies, the Commission should take other steps to ensure the preservation and advancement of universal service in a rapidly evolving marketplace. The Commission should expand the contribution base for the universal service fund to include all providers of interstate retail telecommunications. For example, it should count revenues from IP telephony the same as all other telecommunications services. Likewise, cable operators and other competing providers of broadband services should be required to contribute to the universal service fund to the same extent ILECs are required to contribute based on DSL revenues. SBC will address these issues in the Commission's separate rulemaking proceedings to consider expanding the universal service contribution base to include all competing providers of broadband Internet access³⁶ and to consider implementing changes to the existing universal service contribution and recovery process.³⁷

³⁶ Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities; Universal Service Obligations of Broadband Providers; and Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services; 1998 Biennial Regulatory Review – Review of Computer III and ONA Safeguards and Requirements, CC Docket Nos. 02-33, 95-20, and 98-10, Notice of Proposed Rulemaking, 17 FCC Rcd 3019 (2002).

³⁷ Federal-State Joint Board on Universal Service et al., CC Docket Nos. 96-45, 98-171, 90-571, 92-237, 99-200, 95-116, 98-170, Further Notice of Proposed Rulemaking and Report and Order, 17 FCC Rcd 3752 (2001).

Second, SBC's proposal is consistent with Section 254(b)(1) because it will ensure that services are available at "just, reasonable and affordable" prices. It should not be difficult for the Commission to establish general rules for ensuring that prices for residential local service are "just and reasonable." As previously discussed, that standard is already reflected in Section 201(b) of the Act and has formed the basis of the Commission's review of tariff prices for many years. The Commission, however, must make it clear that a just and reasonable price for a retail telecommunications service is not limited to the recovery of forward-looking costs. Although it may be appropriate to limit universal service funding to forward-looking cost in order to encourage efficiency, the appropriate cost structure for retail costs is an entirely different manner. A carrier must have the ability to recover its actual costs, as opposed to the theoretical forward-looking costs of a hypothetical efficient competitor, through its retail prices.

SBC recognizes that a just and reasonable price may be unaffordable in particular geographic areas. Therefore, SBC proposes to allocate universal service funding that is sufficient to ensure that prices can be set at affordable levels. The standard definition of "affordable" is something that can "be borne without suffering serious detriment." As with other key terms used in section 254, this term should be viewed as inherently relative. SBC believes that the term "affordable" must necessarily involve some comparison between the costs of providing service to the ability of consumers to pay for service. Eventually, if rates exceed a certain level, they exceed the ability of consumers to pay for the service. In this sense, the statutory requirement that rates be "affordable" can be thought of as a rate ceiling above which explicit universal service support should be made available for cost recovery purposes.

Without commenting on the relative importance of intrastate and interstate retail universal service to other household expenses, these costs represent a typical household expense for residence customers, such as cable television charges, transportation expenses, and the costs of household utilities like water, gas and electricity. As previously discussed, a comparison of

³⁸ Webster's Collegiate Dictionary 20 (10th ed. 1993).

residential local telephone service levels to other household expenses demonstrates that residential customers are spending less for such service than for other household items. This comparison further supports the position that customers can afford to pay a price that recovers a larger percentage of the cost of providing local telephone service, rendering unwarranted any higher levels of subsidy. If necessary, the Commission can expand the Lifeline program to assist individual residential customers who do not have the ability to pay the price established by the affordability benchmark.

The Commission's current cost benchmark does not consider whether current below-cost prices are affordable or whether self-supporting prices would be affordable. It simply compares the hypothetical cost of providing service in a state with the nationwide average hypothetical cost of providing service and provides support where the state's hypothetical cost exceeds the nationwide average hypothetical cost by an arbitrary level. There is no way to determine whether the cost benchmark produces sufficient support to maintain affordable prices because the provision of support has bears no relation to whether prices are affordable. affordability benchmark proposal relies upon the relationship between the self-supporting price of residential local service in a particular geographic area and the median income for that area to determine whether prices should be considered affordable or unaffordable from a public policy perspective. Support would be provided only for areas where self-supporting prices are determined to be unaffordable.

Third, SBC's proposal is consistent with Section 254(b)(3) because it will ensure that the prices paid by consumers in "rural, insular, and high cost areas" are "reasonably comparable" to the prices paid by consumers in urban areas. The Commission originally chose to define "reasonably comparable" as a "fair range of urban/rural rates both within a state's borders, and among states nationwide." Such a definition, however, creates more questions than it answers. One problem is that "fair" is an inherently loaded word. More importantly, a fairness standard is

³⁹ Seventh Universal Service Order, at ¶ 30.

ambiguous and grants the Commission virtually unlimited discretion to determine when prices are reasonably comparable, based solely on a subjective determination of what constitutes a fair range of rates.

The Commission could not simply compare *existing* prices in rural and urban areas in response to the Tenth Circuit's remand because the results of such a comparison would be meaningless. As previously discussed, current prices in rural and urban areas are distorted because of implicit subsidies — in some cases, prices in rural areas are actually lower than the prices in urban areas. Therefore, the Commission cannot assess reasonable comparability until after it rationalizes local prices and implements an affordability-based explicit universal service mechanism.

SBC's proposal addresses concerns about reasonable comparability by providing explicit universal service support that is sufficient to cover the forward-looking costs of providing basic local telephone service in a given geographic area. This takes account of the higher costs in rural and insular areas to a much greater degree than the Commission's averaging approach. Further, the affordability benchmark takes account of the ability of residential customers in a given geographic area to pay for telephone service. If customers in rural and insular areas are not able to pay for telephone service, it will be reflected in the affordability benchmark. At the same time, the affordability benchmark will identify rural and insular areas where customers *are* able to pay for telephone service and thus are not in need of universal service support.

SBC believes the "reasonably comparable" requirement should be interpreted in a fashion that suggests that some differences are reasonable, as long as there is some common, relevant point of reference between the prices being compared. If Congress had intended for reasonable comparability to mean "numerical equality," then it simply could have used language similar to what appears in section 254(g) of the Act, which requires that "rates charged by providers of interexchange telecommunications services to subscribers in rural areas "shall be no higher than the rates charged by each such provider to its subscribers in urban areas." Because Congress did not use such language, reasonable comparability should be interpreted as accommodating a

range of prices that are based on a common affordability standard. In fact, an overly narrow construction of reasonable comparability would be exceedingly difficult to satisfy in light of the fact that rural costs may be a hundred times greater than costs in urban areas.⁴⁰ It is precisely for this reason that the Commission cannot undertake to analyze, determine, and prescribe the reasonable comparability of prices in a vacuum.

The Commission must balance reasonable comparability with other statutory universal service requirements, such as affordability. SBC's proposal emphasizes affordability, which ensures universal service in rural and high-cost areas while also accommodating reasonable price differences between rural and urban areas. Once residential local prices rise to affordable levels and affordability-based federal and state universal service support mechanisms are established, any price differences that exist between rural areas and urban areas should be considered reasonably comparable because prices charged in both areas are affordable. It would be inefficient to provide additional universal service support to reduce prices in rural areas below their affordable level simply to create price equality with urban areas. Likewise, it would be inefficient to increase prices in rural areas above their affordable level in cases where prices in urban areas are higher. The Tenth Circuit noted in its decision that the Commission must balance the statutory universal service requirements against one another and should work to achieve each one.⁴¹ Accordingly, the Commission cannot adopt an overly broad definition of reasonable comparability that creates a conflict with equally important requirements, such as keeping prices in urban areas affordable and avoiding excess subsidization that would violate the sufficiency requirement.⁴²

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 $^{^{40}}$ *NPRM*, at ¶ 16.

⁴¹ Qwest v. FCC, 258 F.3d at 1199-1200.

⁴² *Id.*, at 1200 (citing Alenco Comm. v. FCC, 201 F.3d 608, 620 (5th Cir. 2000)).

V. The Commission Has the Authority to Implement a Comprehensive Plan for Universal Service

The Commission has the authority, but also the obligation, to end reliance on implicit subsidies and implement meaningful universal service reform. Such a plan is meaningless unless it rationalizes local prices and removes implicit subsidies from intrastate services. Although universal service support comes from both federal and state mechanisms, ultimately all of this support is being used for a single service — residential local telephone service. Thus, both the Commission and the states must assume responsibility for implementing universal service reform.

The Tenth Circuit's decision in *Qwest v. FCC* stands for the proposition that the Commission has an obligation to ensure that states take the necessary action to achieve the requirements of Section 254. Among other things, the court held that the Commission improperly "base[d] its policies on the principle that there should be sufficient state mechanisms to promote universal service" without "ensur[ing] that these mechanisms exist." While the court recognized that it was probably necessary for the Commission to rely on state action to help implement universal service, the court nevertheless held that the Commission could not simply *assume* that states will act on their own to preserve and advance universal service. On remand, the Commission is required to "develop mechanisms to induce adequate state action" and to "explain further its complete plan for supporting universal service."

The court's holding reflects the Commission's expanded responsibility for universal service as a result of the 1996 Act. Indeed, just as sections 251 and 252 significantly expanded the Commission's authority over intrastate services to facilitate the introduction of competition in the local market, section 254 significantly expanded the Commission's authority to provide

⁴³ *Id.*, at 1203.

⁴⁴ *Id.*, at 1204.

⁴⁵ *Id.*, at 1204-05.

universal service support for local services. There are numerous examples of this delegation in section 254. For example, section 254(a)(2) directs the Commission, with input from the Federal-State Joint Board on Universal Service, to conduct a proceeding to implement a federal universal service mechanism. In addition, section 254(c) directs the Commission to maintain an evolving definition of universal service that takes into account advances in telecommunications and information technology and services, and section 254(d) requires the Commission to establish a mechanism for collecting universal service contributions from providers of interstate telecommunications services providers (and providers of interstate telecommunications if the Commission determines it is in the public interest). The Commission also has the responsibility under section 254(h)(2) for establishing rules to enhance the availability of advanced services for schools, health care facilities and libraries.

At the same time, the court's holding reflects the fact that Congress plainly contemplated a partnership between the Commission and the states to support universal service.⁴⁶ The court itself noted numerous examples illustrating Congress' intent: (i) section 254(b)(5) provides that "there should be specific, predictable and sufficient Federal and State mechanisms to preserve and advance universal service;" (ii) section 254(f) provides that "[e]very telecommunications carrier that provides intrastate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, in a manner determined by the State to the preservation and advancement of universal service; and (iii) section 254(k) provides that both the Commission and the states must "ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those In addition to these statutory provisions, section 254(f) provides that a state is prohibited from adopting regulations that are inconsistent with the Commission's rules to preserve and advance universal service, and section 254(i) provides that "the Commission and

⁴⁶ *Id.*, at 1203.

the States should ensure that universal service is available at rates that are just, reasonable and affordable."

SBC believes the only way to make sense of this statutory scheme is to assume that Congress intended to establish a dual-jurisdiction regime similar to the one established in sections 251 and 252. Therefore, the Supreme Court's analysis of the jurisdictional balance struck by sections 251 and 252 is instructive. In reviewing the Commission's rules implementing sections 251 and 252, the Supreme Court confirmed the Commission's jurisdiction to adopt rules governing matters to which the 1996 Act applies.⁴⁷ It held that Section 201(b) provides the Commission with rulemaking authority to carry out the "provisions of this Act," which includes the provisions of Sections 251 and 252 added by the 1996 Act.⁴⁸ The Supreme Court concluded that the Commission's prescription of a pricing methodology through rulemaking does not prevent the states from establishing rates, because it is the states that "determine the concrete result in particular circumstances." The argument for applying the Supreme Court's reasoning to the universal service provisions of the 1996 Act is bolstered by the fact that section 254(f) and 252(c) both require that the states' actions must be consistent with the Commission's regulations.

Clearly, the Commission must do more than just establish a limited amount of federal universal service support without any knowledge, let alone assurance, of what states are doing to promote universal service. The elimination of implicit subsidies and implementation of residential pricing reform are essential components of meaningful universal service reform. Anything less would not "preserve and advance universal service," as required by Section 254(f), and would maintain unlawful implicit subsidies. As previously discussed, both Congress and the Commission have recognized that implicit subsidies are not sustainable in a competitive

⁴⁷ AT&T Corp. v. Iowa Util. Bd., 525 U.S. at 366.

⁴⁸ *Id.* (citing 47 U.S.C. § 201(b)).

⁴⁹ *Id.*. at 384.

environment and that regulators cannot continue to rely on implicit subsidies as a source of

universal service support. Accordingly, the Commission has the authority to institute

comprehensive universal service reform and to establish inducements for the states to reform

residential local prices and end reliance on implicit subsidies from various sources such as toll

services, intrastate switched access, business services, and statewide average prices by a date

certain.

VI. Conclusion

For these reasons, the Commission should not respond to the Tenth Circuit's remand

decision in *Qwest v. FCC* by simply defending its reverse-engineered 135% benchmark model,

comparing rural and urban prices, and encourage the states to implement universal service

reforms. Instead, the Commission should implement a national plan for universal service that

ends the longstanding reliance on implicit subsidies as the primary source of universal service

support. This can be accomplished by implementing a transition to rationalized local prices and

establishing an integrated, affordability-based universal service mechanism.

Respectfully submitted,

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